

**Franchise Tax Board****ANALYSIS OF ORIGINAL BILL**

Author: Dutton Analyst: Raul Guzman Bill Number: SB 1639  
Related Bills: See Legislative History Telephone: 845-4624 Introduced Date: February 24, 2006  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Employer Provided Qualified Health Insurance Credit

**SUMMARY**

This bill would create a tax credit for taxpayers that provide qualified health insurance for their employees.

**PURPOSE OF THE BILL**

According to the author's office, the purpose of this bill is to increase the number of people in this state that have health insurance.

**EFFECTIVE/OPERATIVE DATE**

This bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2007, and before January 1, 2012.

**POSITION**

Pending.

**ANALYSIS**FEDERAL/STATE LAWFEDERAL LAW**Employer Deductions**

Existing federal law allows ordinary and necessary business expenses to be deducted, including health care coverage premiums paid by an employer for accident or health plans for employees.

Existing federal law also allow self-employed persons to deduct from gross income 100% of amounts paid for health insurance for themselves and their spouses and dependents.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <input checked="" type="checkbox"/> PENDING

Department Director

Date

S. Stanislaus

5/1/06

### **Employee Exclusion From Gross Income**

Under federal law, a health savings account (HSA) means a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary. HSAs are available to individuals who are covered under a high deductible health plan (HDHP) and are not covered under any other health plan that is not a high deductible plan. The amount of an employer's contribution, including a salary reduction contribution made through a cafeteria plan, to an accident or health plan for the benefit of an employee or the employee's spouse or dependents is excluded from the employee's gross income.

Under federal law, an HDHP for 2004 means a health plan with an annual deductible of at least \$1,000 for individual coverage (\$2,000 for family coverage) and maximum out-of-pocket expenses of \$5,000 for individual coverage (\$10,200 for family coverage).

### **CALIFORNIA LAW**

#### **Employer Deductions**

California law conforms to the federal rules relating to ordinary and necessary expense deductions and the self-employed health insurance deduction.

#### **Employee Exclusion From Gross Income**

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal personal income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA, including salary reduction contributions made through a cafeteria plan, made on the employee's behalf by their employer is added to AGI on the employee's California return.

Existing federal and state laws provide various tax credits designed to provide tax relief to taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). Current state laws do not provide tax credits for any health care costs.

### **THIS BILL**

This bill would allow a 15% credit for amounts paid during the taxable year by a taxpayer to an HSA on behalf of employees. The credit would be available for taxable years beginning on or after January 1, 2007, and before January 1, 2012.

This bill would specify the following:

- No deduction would be allowed for the same expenses for which the credit was allowed.
- Unused credits can be carried over to future years until the credit is exhausted.
- Franchise Tax Board would be required to provide a report on the usage of this credit to the Legislature on or before September 1, 2010.
- The Legislative Analyst would be required to provide a report to the Legislature on the effectiveness of the tax credit on or before March 1, 2011.

This bill would allow the credit to Personal Income Tax (PIT) taxpayers and Corporate Tax Law (CTL) taxpayers.

### **IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Many businesses have employees in more than one state. Currently, this bill would allow a credit for health insurance cost for employees that are employed by the taxpayer regardless of where they are in the world. If the author's intent is to limit the health insurance cost to employees in California, this bill would need to be amended; however, if the bill were limited to employees in California, a constitutional issue could be raised, which is discussed below under "Legal Impact."

This bill specifies that the FTB is to provide a report to the Legislature on or before September 1, 2010, on the usage of this credit, but lacks specificity on what information FTB's report should contain.

### **LEGISLATIVE HISTORY**

SB 1787 (Ackerman, 2005/2006) would retroactively conform to the federal HSA provisions starting with tax year 2004 and would allow amended returns to be filed. That bill is currently in the Senate Revenue and Taxation Committee.

AB 2010 (Plescia, 2005/2006) would conform to the federal HSA provisions starting with tax year 2007. That bill is currently in the Assembly Revenue and Taxation Committee.

SB 1584 (Runner, 2005/2006) would conform to the federal HSA provisions starting with tax year 2006. That bill is currently in the Senate Revenue and Taxation Committee.

SB 2737 (Nakanishi, 2005/2006) would create a tax credit for small employers that provide health coverage to their employees. That bill is currently in the Assembly Revenue and Taxation Committee.

SB 195 (Maldonado, 2005/2006) would have created a tax credit for small employers that provided health coverage to their employees. That bill failed to pass out of the house of origin.

AB 1262 (Campbell), AB 1734 (Thomson), and AB 2765 (Knox), from the 1999/2000 legislative sessions, and AB 694 (Corbett) and AB 39 (Thomson/Campbell), from the 2001/2002 sessions, would have created an employer provided health insurance type credit. These bills failed passage in the Assembly.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of these states provides a credit comparable to the credit this bill would allow.

## FISCAL IMPACT

Implementing this bill would require the creation of a new tax form, some changes to existing tax forms and instructions, and some changes to the department's information systems. All of these changes could be accomplished during the department's normal annual update.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of SB 1639 Enactment Assumed After June 30, 2006 (in Millions)			
	2006-7	2007-8	2008-9
Revenue Impact	-\$5	-\$20	-\$35

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

The assumptions and parameters included in the estimates are based on state employment data from the Employment Development Department (EDD), information from industry experts, and literature related to the U.S. and California health care industry.

Based on surveys published by the health care industry, it was estimated that on average 18% of employees in small firms (2 to 199 employees) and 8% in large firms receive high-deductible insurance from their employers. Based on these percentages and EDD employment data, the number of employees with high-deductible insurance is projected to be about 2,300,000 for 2007. Only 85% of these, or about 1,955,000 employees, were assumed to work in taxable organizations. It is assumed that 2% of these employees, or about 39,000, would receive employer contributions to HSAs because of the incentive effect of the proposal. Because of the broad language of the proposal, it is assumed that contributions to HSAs on behalf of all the employees of a business firm would qualify for the credit, even if those employees were located in the rest of the United States. This was projected to expand the employee base three fold to about 120,000. Employer contributions to HSAs were assumed to average \$1,200 per year per employee in 2007. This amount was grown at a rate of 5% per year after 2007. It was estimated that a total of \$141 million of employer contributions would be made in 2007. With a credit rate of

15%, this translates into \$21 million of potential tax credit. Approximately 55% of this amount, or about \$12 million, was projected to be used due to sufficient tax liability. The unused credits would be carried forward until exhausted.

This would have an additional tax revenue impact of about \$7 million ( $\$141 \text{ million} \times 0.55\% = \$78 \text{ million}$ ) at a tax rate of 8.84% ( $\$78 \text{ million} \times 8.84\% = 7 \text{ million}$ ), for a total of \$19 million ( $\$12 \text{ million} + \$7 \text{ million} = \$19 \text{ million}$ ). Employers would lose deductions in the amount of \$7 million because the contributions to the health plans are in lieu of wages. Therefore, the net revenue impact of the proposal for this group of employees is projected to be \$12 million.

Based on the same data, the number of employees without any insurance in 2007 is projected to be about 2,200,000 of whom 85%, or 1,840,000, work in taxable organizations. It was assumed that 1% of employees in small firms and 0.5% in large firms would receive high deductible insurance plans with employer contributions. This would result in 18,000  $[(0.01 \times 1,797,000) + (0.005 \times 44,000)]$  California employees. Adjusting for worldwide employment as above at three fold, about 56,000 ( $3 \times 18,000$ ) employees would receive HDHP insurance with employer contributions. For this group, employers would pay the insurance premiums as well as contribute \$1,200 per year to employee HSAs. The contributions to HSAs would amount to about \$65 million ( $\$1,200 \times 56,000$ ) resulting in \$10 million potential tax credit at 15%. Of this amount only 55% or \$5.5 million would be used due to sufficient tax liability. Unused credits would be carried forward until exhausted. The offsetting deductions were estimated to be about \$3 million ( $\$65 \text{ million} \times 55\% = \$36 \text{ million} \times 8.84\% \text{ tax rate} = 3 \text{ million}$ ) so that the net of credits revenue impact equals \$2.5 million.

The average monthly premium cost for HMOs for 2004 was about \$260. The average premium for high-deductible health insurance was assumed to be about half of this amount or \$130 per month. A 10% annual growth rate was assumed for the premiums. This resulted in an estimated annual premium of about \$2,000 for 2007 ( $\$130 \text{ per month} \times 12 \text{ months} \times \text{growth factor of } 1.33 \text{ for three years from } 2004 \text{ to } 2007$ ). Assuming a tax rate of 5% for the employees would result in \$9 million of tax revenue impact of these offsetting deductions. The total revenue impact of the proposal for this group of employees would therefore amount to about \$11.5 ( $\$9 \text{ million} + \$2.5 \text{ million}$ ). The total revenue impact of the proposal was estimated to be about \$23 million for 2007, ( $\$11.5 \text{ million of revenue impact for this group} + \$12 \text{ million for the previous group} = \$23 \text{ million}$ ).

## LEGAL IMPACT

If this bill requires taxpayers to provide health insurance to employees located within or residents of California in order for the costs to qualify for this credit, the credit may be subject to constitutional challenge. The U.S. Court of Appeals for the 6<sup>th</sup> Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738, that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. This case is now pending with the U.S. Supreme Court. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its effects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

## **POLICY CONCERNS**

This bill leaves the number of years for the carryover period unlimited. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limit since experience shows credits typically are exhausted within eight years of being earned.

## **LEGISLATIVE STAFF CONTACT**

Raul Guzman  
Franchise Tax Board  
845-4624  
[raul.guzman@ftb.ca.gov](mailto:raul.guzman@ftb.ca.gov)

Brian Putler  
Franchise Tax Board  
845-6333  
[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)